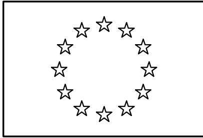

EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

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DECEMBER 2004 UPDATE OF THE CONVERGENCE PROGRAMME OF HUNGARY (2004-2008)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

The update of the Hungarian convergence programme was submitted on 1 December 2004 and covers the period between 2004 and 2008. It broadly complies with the data requirements of the "code of conduct on the content and format of stability and convergence programmes". While it contains all the compulsory data, the primary balance is not calculated according to the conventional definition. Some optional data such as on long-term health care expenditure are also missing.

The macroeconomic scenario presented in the update is rather favourable. It foresees a continuation of the recovery in economic activity with gradually increasing real GDP growth from 3.9% in 2004 to 4.6% in 2008. For the years 2005-2006, the projections of the update are slightly higher than those of Commission services in the autumn 2004 forecast, with real GDP growth being projected at 4.0% in 2005 and 4.2% in 2006 compared with 3.7% and 3.8%. Similarly, while Commission forecasts are not available for the other years, the growth projections in the update for the outer years also seem to be on the optimistic side. According to Commission services calculations applying the commonly agreed methodology to the figures of the programme, real GDP growth would be above potential over 2007-2008. The corresponding output gap decreases moderately from just above to just below -1% between 2004 and 2006; for the years 2007 and 2008 it drops sharply to around zero.

The renewed disinflation process that started in the second half of 2004 is projected to continue over the programme horizon and inflation would drop to 3% by 2008. The interest rate projections in the programme appear rather favourable. Their fulfilment would require an environment of significantly improved confidence, characterized by substantially lower inflation than currently is the case, improved fiscal and current account balances as well as renewed confidence of market participants in the euro adoption strategy. The update maintains the 2010 target date for euro adoption.

The decision by Eurostat of 23 September 2004 allows a temporary classification until the March 2007 fiscal notification of second pillar pension funds inside the general government. The Hungarian authorities decided to avail themselves of this possibility and presented general government deficit figures excluding the second pillar burden created by the 1998 pension reform. Compared to the May 2004 programme, this reclassification lowers the yearly deficit figures by 0.8-1 percentage point between 2004 and 2008. For the sake of comparison with the previous programme and with the Commission services autumn 2004 forecast, and given that the final 2008 target will not benefit from this reclassification, figures used in the assessment both include and exclude such burden created by the pension reform.

The update foresees the following general government deficit: 4.5% of GDP in 2004, 3.8% in 2005, 3.1% in 2006, 2.4 in 2007 and 1.8% of GDP in 2008. (Including the

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[1] This technical analysis, which is based on information available up to 9 February 2005, accompanies the recommendation by the Commission for a Council opinion on the update of the convergence programme, which the College adopted on 16 February 2005. It has been carried out by the staff of and under the responsibility of the Directorate-General for Economic and Financial Affairs of the European Commission. Comments should be sent to Viktória Kovács (viktoria.kovacs@cec.eu.int) and Barbara Kauffmann (barbara.kauffmann@cec.eu.int).

burden of the pension reform, the projected general government deficit path would be 5.3%, 4.7%, 4.1%, 3.4% and 2.8% of GDP between 2004 and 2008; hence it keeps the target date to correct the excessive deficit.) In the light of the sizeable deviation from the 2004 target of 4.6% of GDP including the burden of the pension reform contained in the May convergence programme - outturn estimated by the update at 4.5% of GDP (5.3% of GDP including the burden of the pension reform), which is in line with the revised target -, it changes the frontloaded adjustment path of the May 2004 programme to a more linear consolidation trend until the end of the programme period. After the estimated consolidation of 0.9 percentage point of GDP in 2004, it now projects an annual adjustment of some 0.6-0.7 percentage point for the remaining years, instead of the originally planned yearly adjustment of ½ a percentage point. The update maintains a consolidation strategy based on a reduction of the expenditure ratio (from 44.8% of GDP in 2004 to 43.4% in 2008), which is supposed to be underpinned by structural reforms, and coupled with a more moderate decline in the revenue ratio. The most pronounced expenditure reduction would occur in 2005. However, this is mainly based on a 0.5 percentage point decline in the interest burden, and by a 1.7 percentage point expenditure reduction for public investment. This large decline in public investment in 2005 would be partly compensated by higher investment in the following years, thereby leading to a decrease by 0.6 percentage point in the public investment ratio between 2004 and 2008. The drop in public investment expenditure would be compensated by increased recourse to PPP projects. The primary deficit, after an improvement by 1.2 percentage point in 2004, would register an annual decline of about 0.3-0.4 percentage point during the remaining years so that, including the burden of the pension reform, a slight surplus would be reached in 2008 when the transitory period provided by Eurostat until the March 2007 notification for the accounting of such item will already have expired.

The adjustment path described in the programme and in particular the new deficit target for 2005 of 3.8% of GDP (4.7% of GDP including the burden of the pension reform) can be considered appropriate to correct the excessive deficit by 2008 provided that it is backed by sufficient measures. However, the final target of 2.8%[2] of GDP only leaves a small safety margin, which might be reduced further because of a change in the starting position as there are still some uncertainties linked to the outcome of the 2004 budget.[3] Furthermore, the budgetary outturn for 2005 to 2008 may be worse than projected. (i) The macroeconomic scenario being rather favourable indicates that revenues could turn out lower and expenditures higher than expected. As suggested by the Commission services Autumn 2004 forecast (projecting 5.2% of GDP for 2005 and 4.7% of GDP for 2006 including the burden of the pension reform; or 4.3% and 3.7% of GDP excluding this burden), meeting the budgetary targets for 2005 and 2006 seems to be subject to some risks. For 2005, this takes into account that the Government has established an

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[2] This figure includes again the burden of the pension reform since according to Eurostat the exclusion of this item is only possible until the March 2007 fiscal notification.

[3] The difference between the cash based and the accrual based data is not yet known. Due to EU accession related reasons, notably the changes in the collection of VAT on intra EU imports, this difference was assumed to be unusually high in 2004, amounting between 1.2 - 1.4 percentage points. However, there are accounting uncertainties related to agricultural subsidy payments and the payment of the 13th salary to public employees. Therefore, the difference between cash and accrual accounting might turn out lower, thereby increasing the accrual based deficit in 2004. If the refunds of VAT are accelerated, as was indicated by the Hungarian authorities, they might increase the (accrual based) deficit of 2004 by almost 0.7 percentage points.

"emergency" reserve package of 0.5% of GDP against a possible undershooting of the 2005 target. While the existence of this reserve is welcome, the amount allocated to it seems insufficient, in view of the risks surrounding the Budget 2005. Furthermore, there are concerns that freeing of these reserves could occur too early in the year, thereby reducing the incentives for a rigorous implementation of the 2005 budget. Missing the 2005 and 2006 targets would increase the further adjustment needed in the years 2007 and 2008. (ii) Possible cuts in VAT rates in the framework of the ongoing tax reforms could increase the risk to revenues even if they compensated by an increase in other rates; its timing would therefore require careful consideration and it would need to be made conditional upon the full achievement of deficit targets. (iii) The adoption of intended reform measures constituting the base of future expenditure cuts is not yet secured. Furthermore, most of the expenditure-reducing measures contained in the 2005 budget are not backed by comprehensive reforms. (iv) The interest rate assumptions of the update, which are conditional on a further restoration of confidence, may not materialise in the following years, with such favourable time profile. (v) It also appeared that VAT refunds originating from economic activities in 2004 may not be fully disbursed in time to avoid burdening the 2005 (accrual based) budget, but the authorities have committed to accelerate these refunds so that they will not burden the 2005 budget. On the other hand, this strengthened control on VAT refunds initiated end-2004 might contribute to a reduction of the expected shortfall of VAT revenues, which constitutes a positive risk.

In view of this assessment, there is a risk that budgetary outcomes could be worse than projected in the update. Therefore, although the adjustment path contained in the programme seems adequate, the measures outlined in the programme do not appear to comply with this path and therefore may not ensure that the deficit (including the burden of the pension reform) is reduced to below 3% of GDP by 2008. In order to respect such an adjustment path, additional measures are needed. In particular, it seems paramount to meet the new 2005 target, which, in view of the above assessment, would imply that additional measures of at least ½ a percentage point appear necessary.

The debt ratio, which increased to 57.3% of GDP in 2004 (59.9% of GDP including the burden of the pension reform), is expected to gradually decrease again from 2005, triggered by the continuous lowering of the general government deficit and the declining interest burden on the debt stock. It is expected to fall below 50% of GDP in 2008 (or to reach just above 53% of GDP including the burden of the pension reform). This decline is planned to be supported by a change in the debt management strategy, resulting in savings on interest expenditure. Risks to the debt ratio correspond to those for the deficit projections.

The May 2004 convergence programme announced structural reforms (in particular in the areas of public administration, education and health) to back the expenditure control underlying its strategy. The 2005 budget contains a number of measures aimed at improving efficiency in the central government sector. However, these do not correspond with the ambitious plans of the May programme. While the update gives more details about specific planned reform steps, it still does not quantify their expected effects nor does it detail their state of implementation. This suggests that the more comprehensive reforms of the health and education sector will indeed be postponed until after the elections in 2006, as recently indicated by the government.

With regard to the long-term sustainability of the public finances, Hungary appears to be at some risk on grounds of the projected budgetary costs of an ageing population. Risks

are in part related to the uncertainty regarding the long-term budgetary trends due to the lack of information on health-care expenditure projections. The reformed pension system, including the introduction of the funded second pillar, contribute consistently to reducing the budgetary impact of ageing and to reducing risks of unsustainable public finances. However, it is imperative to pursue other reforms, particularly in the field of health care as well as to resolutely implement the planned budgetary consolidation in the medium term.

The economic policies outlined in the update are partly consistent with the country-specific broad economic policy guidelines in the area of public finances. The general government deficit was to be reduced "in a credible and sustainable way within a multi-annual framework in line with the decisions to be taken by the Council in the context of the budgetary surveillance exercise". However, Hungary has not complied with the 104(7) recommendations of the Council of 5 July 2004 under the excessive deficit procedure, as decided by the Council on 18 January 2005 based on Article 104(8) of the Treaty. The update retains a multi-annual framework for correcting the excessive deficit by 2008, although there is a risk of a worse-than-projected budgetary outcome.

In view of the above assessment and in the light of the recommendations made by the Council under Article 104(7), it would be appropriate for Hungary to (i) take action in a medium-term framework in order to bring the deficit (including the burden of the pension reform) below 3% of GDP by 2008 in a credible and sustainable manner, in particular through additional measures to achieve the new adjustment path including the new deficit target of 3.8% of GDP (4.7% of GDP including the burden of the pension reform) in 2005, and by seizing every opportunity to accelerate the fiscal adjustment; (ii) make the timing and implementation of any tax cuts conditional upon the achievement of the deficit targets of the convergence programme update submitted in December 2004; (iii) progress with the envisaged reforms of the public administration, health and education systems as committed also with a view to improving the long-term sustainability of the public finances.

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008
Real GDP (% change)	**CP Dec. 2004**	**3.9**	**4.0**	**4.2**	**4.3**	**4.6**
	COM	3.9	3.7	3.8	n.a.	n.a.
	CP May 2004	*3.3-3.5*	*3.5-4.0*	*cca.4*	*4.0-4.5*	*4.5-5.0*
HICP inflation (%)	**CP Dec. 2004**	**6.8**	**4.5**	**4.0**	**3.5**	**3.0**
	COM	6.9	4.6	4.2	n.a.	n.a.
	CP May 2004	*cca.6.5*	*cca.4.5*	*cca.4*	*cca.3.5*	*cca.3*
General government balance (% of GDP)	**CP Dec. 2004 adjusted** [1]	**-4.5**	**-3.8**	**-3.1**	**-2.4**	**-1.8**
	non adjusted	**-5.3**	**-4.7**	**-4.1**	**-3.4**	**-2.8**
	COM	-5.5	-5.2	-4.7	n.a.	n.a.
	CP May 2004	*-4.6*	*-4.1*	*-3.6*	*-3.1*	*-2.7*
Primary balance (% of GDP)	**CP Dec. 2004 adjusted** [1]	**-0.3**	**0.0**	**0.3**	**0.7**	**1.1**
	non adjusted	**-1.1**	**-0.9**	**-0.7**	**-0.3**	**0.1**
	COM	-1.1	-1.2	-1.1	n.a.	n.a.
	CP May 2004	*-0.5*	*-0.2*	*0.1*	*0.3*	*0.4*
Government gross debt (% of GDP)	**CP Dec. 2004 adjusted** [1]	**57.3**	**55.3**	**53.0**	**50.6**	**48.3**
	non adjusted	**59.9**	**58.6**	**56.8**	**54.9**	**53.2**
	COM	59.7	59.5	58.9	n.a.	n.a.
	CP May 2004	*59.4*	*57.9*	*56.8*	*55.6*	*53.7.*

Note:

1 The decision by Eurostat of 23 September 2004 allows a temporary reclassification until the March 2007 fiscal notification of second pillar pension funds inside the general government. The Hungarian authorities decided to avail themselves of this possibility and presented the deficit figures by subtracting the burden created by the 1998 pension reform from the general government deficit. Compared to the May 2004 programme, this lowers the yearly deficit figures by 0.8-1 percentage point between 2004 and 2008. For the sake of comparison with the previous programme and with the Commission services autumn 2004 forecast, and given that the final 2008 target will not benefit from this reclassification only adjusted but also non-adjusted figures are shown.

Sources:

Convergence programme (CP); Commission services autumn 2004 economic forecasts (COM); Commission services calculations.

1. INTRODUCTION

After its approval by the Hungarian government, the first update of the Hungarian convergence programme was submitted on 1 December 2004. It is based on the 2005 state budget and covers the period between 2004 and 2008. The update broadly complies with the data requirements of the "code of conduct on the content and format of stability and convergence programmes". While it contains all the compulsory data, the primary balance is not calculated according to the conventional definition[4]. Some optional data are also missing, such as long-term health care expenditure. Moreover, detailed projections for revenue and spending categories would have allowed a deeper analysis of the quality of the projected budgetary adjustment

2. MACROECONOMIC DEVELOPMENTS

The macroeconomic scenario presented in the update is based on a continuation of the recovery which started at end-2003. Real GDP growth would continue to be driven by exports and fixed investment, whereas private consumption is expected to remain subdued, reflecting the positive change in the composition of growth. The update expects real GDP growth to be 3.9% in 2004 and 4.0% in 2005 and to accelerate later on, reaching 4.6% in 2008. The macroeconomic scenario is rather favourable. For the years 2005-2006, the projections of the Commission services in the Autumn 2004 forecast are slightly lower than those of the programme, with real GDP growth being projected at 3.7% in 2005 and 3.8% in 2006 compared with 4.0% and 4.2% respectively in the update. Similarly, growth projections for the outer years also seem to be on the optimistic side. According to Commission services' calculations of potential GDP growth applying the commonly agreed methodology to the figures of the programme, real GDP growth would be above potential over 2007-2008. The output gap would however remain negative until 2008 when it would slightly become positive. Compared to the May 2004 programme, following better-than-expected real GDP growth in the second and third quarters of 2004, the update contains higher short-term real GDP growth figures.

In line with the Commission services Autumn forecast, disinflation is expected to resume in 2005, mainly on account of the vanishing one-off effects of indirect tax hikes in 2004, a strong exchange rate and decreasing inflation expectations. A gradual decline of annual average CPI inflation is expected from 6.8% year on year in 2004 to 3% year on year in 2008. The assumed speed of disinflation seems to be broadly in line with the Commission services' assessment. As a result of the robust growth and measures to promote employment, unemployment is anticipated to decrease further to 5.6% by 2008 and the participation rate is expected to increase to about 64% in 2008 (from around 6% and 60%, respectively, in 2003).

Although the update is based on a slightly more optimistic real GDP growth expectation for the EU-15 member states, the external assumptions behind the programme's macroeconomic scenario are broadly in line with those used by the Commission services in the Autumn 2004 economic forecasts. The favourable interest rate assumptions of the update are based on a further restoration of confidence.

[4] It calculates with net instead of gross interest.

Table 1: Comparison of macroeconomic developments and forecasts

	2004		2005		2006		2007	2008
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	3.9	3.9	3.7	4.0	3.8	4.2	4.3	4.6
Contributions:								
- Final domestic demand	4.4	4.1	3.8	3.9	4.4	4.2	4.3	4.8
- Change in inventories	-0.1	-0.2	-0.5	0.4	-0.3	0.3	0.3	0.0
- External balance on g&s	-0.4	0.0	0.4	-0.3	-0.3	-0.3	-0.3	-0.2
Employment (% change)	0.5	0.5	0.5	0.9	0.6	1.0	1.0	1.4
Unemployment rate (%)	5.8	5.9	5.9	5.9	6.0	5.8	5.7	5.6
HICP inflation (%)	6.9	6.8	4.6	4.5	4.2	4.0	3.5	3.0
GDP deflator (% change)	6.2	6.0	4.3	4.7	3.9	4.3	3.6	3.4
Current account (% of GDP)	-8.7	-9.0	-8.5	-8.5	-8.5	-7.7	-7.2	-6.6

Sources:
Commission services Autumn 2004 economic forecasts (COM); convergence programme update (CP)

The estimates of potential output growth based on Commission services' calculations according to the commonly agreed methodology and consistent with the programme's macroeconomic scenario are somewhat above those in the Commission services Autumn 2004 forecast. The corresponding output gap decreases moderately from just above to just below -1% between 2004 and 2006, for the years 2007 and 2008 it drops sharply to almost zero.

Table 2: Sources of potential output growth

	2004		2005		2006		2007	2008
	COM	CP[3]	COM	CP[3]	COM	CP[3]	CP[3]	CP[3]
Potential GDP growth[1]	3.8	4.0	3.7	3.9	3.7	4.0	3.9	4.0
Contributions:								
- Labour	0.7	0.7	0.6	0.6	0.6	0.6	0.4	0.5
- Capital accumulation	2.2	2.1	2.1	2.2	2.2	2.2	2.3	2.3
- TFP	0.9	1.1	0.9	1.1	0.9	1.1	1.1	1.2
Output gap[1,2]	-0.6	-1.1	-0.7	-1.0	-0.7	-0.8	-0.4	0.2

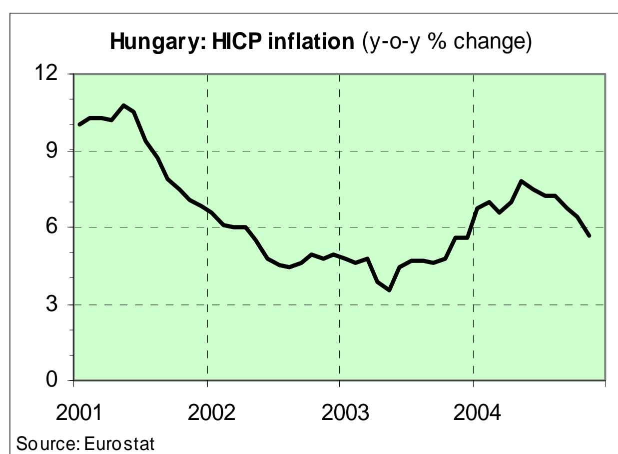
Notes:
[1]based on the production function method for calculating potential output growth
[2]in percent of potential GDP
[3]Commission services calculations on the basis of the information in the convergence programme update (CP)

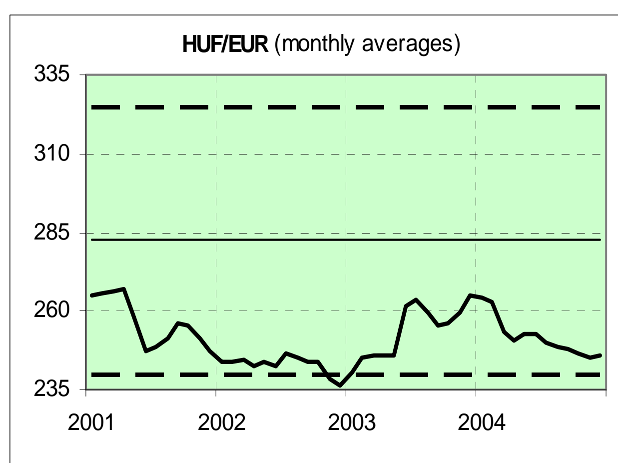
Sources:
Commission services Autumn 2004 economic forecasts (COM); Commission services calculations

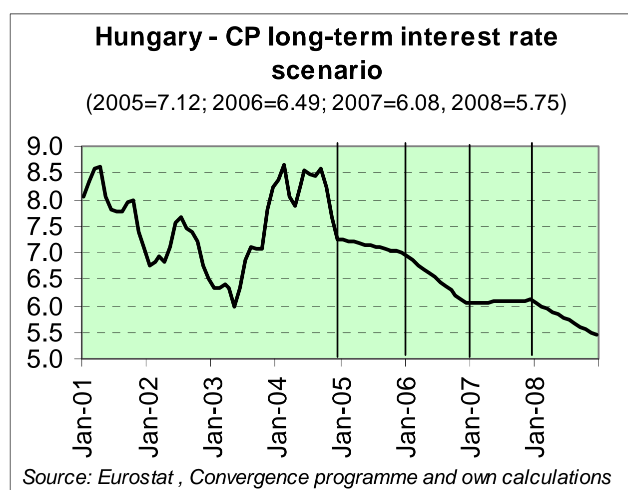
In 2004 the external position of Hungary remained stable after the current account widened to about 9% of GDP in 2003. The update projects a continuous decrease of the current account deficit and the external financing needs. It takes into account the improvement of the capital and financial account owing to EU transfers and the decrease of the financing need of the government and foresees the continuation of the positive structural change from portfolio inflows to FDI financing. The update's medium-term projection for the current account appears to be plausible, though it is on the optimistic side. Its achievement is conditional on the realisation of the reduction of the general government deficit as planned, and the implementation of structural reforms, since it relies on a restoration of credibility that would allow the interest spread to decrease and ensure a stable inflow of FDI.

3. MEDIUM-TERM MONETARY POLICY OBJECTIVES AND THEIR RELATIONSHIP TO PRICE AND EXCHANGE RATE STABILITY

The National Bank of Hungary operates an inflation targeting framework in combination with an exchange rate peg. The forint is pegged to the euro with a ±15% fluctuation band around the central parity. Inflation targets, jointly defined by the government and the bank, are set with a tolerance band of ± 1% at 4% and 3.5% for December 2005 and 2006, respectively. Thereafter, the inflation target is expected to be set at 3%.







The process of gradual disinflation that Hungary had embarked upon in mid-2001 came to a halt in mid-2003, after monthly inflation had reached levels below 4% on the year. Inflation started to accelerate following expansionary fiscal and wage policies, the depreciation of the currency since mid-2003 and hikes in unprocessed food prices. While in May 2004 HICP inflation topped 7.8%, it fell to 5.5% in December, reaching a yearly average of 6.8%. The decline in inflation benefited from a moderation in domestic consumption and a drop in inflation expectations despite the still high growth rate of unit labour costs. In 2004, around one third of the price increase was due to changes in VAT and excise taxes.

Following the increase by 600 basis points in interest rates in the second half of 2003 as a result of repeated turbulences, the Hungarian central bank gradually eased interest rates in 2004 by a total of 300 basis points to 9.5%. At the beginning of the cut cycle in March 2004, the Monetary Council pointed to a better assessment by foreign investors of the risks facing the Hungarian economy. From May onwards, falling inflation rates created room for further cuts. The rate-cutting cycle continued in 2005, with another 50 basis point cut at the January meeting of the Monetary Council.

Reflecting the reduction in policy rates, money market rates also decreased from above 12.5% in January to below 9.5% in December 2004, leading to a spread of about 750 basis points vis-à-vis the euro area. Long-term bond yields hovered around 8 – 8.50% for most of the year. In late autumn 2004, spreads with euro bonds started to decrease and in mid-January they

stood at about 350 basis points, helped by an improvement of the risk perception in relation to a better economic outlook.

The profile envisaged for long-term interest rates – 7.1% in 2005, 6.5% in 2006, 6.1% in 2007 and 5.8% in 2008 – requires a continuous decrease in bond yields over the period. Given that long-term bond yields currently stand at about 7%, the profile, while favourable, may be achievable. Underlying this 125 basis point drop in bond yields is a drop in short-term rates of more than 400 basis points from their current level (9.0%) over a four-year period. Such a substantial decline in long and short-term interest rates would require an environment of significantly improved confidence characterized by substantially lower inflation, improved fiscal and current account balances as well as renewed confidence of market participants in the euro adoption strategy.

After having experienced a quite substantial appreciation trend in the first months of 2004, the Hungarian forint has been fluctuating around a slower appreciating path since April. In the course of 2004, the forint appreciated by about 7% against the euro and is again close to its upper band. While the current exchange rate regime shares some formal features with ERM II, the central parity does not perform the function of core of the system since the exchange rate has been always moving above the central parity, thus the central parity is not the target, and therefore also provides little guidance to market participants. Early in 2004, the lack of nominal convergence and fiscal consolidation prompted a review of the original euro adoption plan, which envisaged euro adoption by 2008. Accordingly, the May 2004 convergence programme set the target year for euro adoption at 2010, assuming that the fiscal and inflation criteria would be met in 2008. The update currently under review maintains the 2010 target date, despite the slower-than-foreseen fiscal consolidation in 2004.

4. BUDGETARY IMPLEMENTATION IN 2004

In February 2004, after re-assessing the risks on the expenditure and revenue sides, the original general government deficit target for 2004 of 3.8% of GDP was officially revised to 4.6% of GDP, which was confirmed in the convergence programme of May 2004. In January 2004, the government adopted a series of expenditure freezes, followed by a smaller correction in March, totalling 1.2% of GDP. Following the Council recommendation of 5 July 2004 regarding the correction of the excessive deficit (see box 1), some further measures aimed at meeting this new target were adopted in the second half of 2004. They included a restriction on the use of carried-over appropriations of ministries (0.5% of GDP) in order to limit possible expenditure slippages, and the adoption of a corrective package, with direct balance-improving effects amounting to 0.2% of GDP. These measures, while having contributed to controlling and reducing the deficit, turned out to be insufficient to meet the target of 4.6% of GDP, which was revised upwards again in September 2004 to 5.3% of GDP. This revision was confirmed in the December 2004 update of the convergence programme[5].

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[5] As also explained in section 5.1, the Hungarian authorities decided in December 2004 to avail themselves of the possibility permitted by Eurostat until the March 2007 notification to temporatily report the general government deficit numbers without the burden of the 1998 pension reform, which amounts to between 0.8 and 1 percentage point of GDP between 2004 and 2008. Accordingly, the (adjusted) revised deficit target excluding the burden of the pension fund contained in the convergence programme of December 2004, is 4.5% of GDP in 2004.

Box 1: The excessive deficit procedure for Hungary

In view of a general government deficit of 5.9% of GDP recorded in 2003[6], the Council decided on 5 July 2004 that Hungary was in excessive deficit and recommended that this situation should be corrected by 2008 at the latest in line with the adjustment path outlined in the May 2004 convergence programme. In particular, Hungary was recommended to "take effective action regarding the measures envisaged to achieve the 2005 deficit target", and to "implement with vigour the measures envisaged in the May 2004 convergence programme, in particular to stand ready to introduce additional measures, if necessary, with a view to achieving the general government deficit target for 2004". In addition, the Council invited the Hungarian authorities "to seize every opportunity to accelerate the fiscal adjustment; to undertake the envisaged reforms of the public administration, health and education systems to ensure the foreseen reduction of the expenditure ratio and to improve the long-term sustainability of the public finances"; and "to ensure that planned tax cuts are adequately financed and make their implementation conditional upon the achievement of the deficit targets".

The Council established the deadline of 5 November 2004 for the Hungarian government in order to "take effective action regarding the measures envisaged to achieve the 2005 deficit target". The Commission, while recognising that the Hungarian government had adopted some measures between July and November 2004, considered that they were insufficient to avoid a sizeable deviation from the targets for 2004 and 2005 and, more generally, from the multi-annual adjustment path until 2008. Therefore, it adopted on 22 December 2004 a recommendation for a Council decision under Article 104(8) that effective action was not taken in response of the 5 July 2004 Council recommendations. Such a decision was taken by the Council on 18 January 2005[7].

Failure to achieve the 4.6% target stems from three factors: an upward revision of the 2003 deficit in the September 2004 fiscal notification (by 0.3% of GDP), expenditure slippages and over-optimistic revenue forecasts, mainly regarding VAT (see box 2). Based on the available cash deficit data, the target for the government deficit in accrual terms of 5.3% of GDP (or 4.5% of GDP without the pension reform burden) could be achievable. However, the final outcome might still turn out significantly higher: (i) The difference between the cash based and the accrual based ESA 95 data is not yet known. Due to EU accession related methodological reasons, this difference was assumed to be unusually high in 2004, amounting between 1.2 - 1.4 percentage points. However, there are accounting uncertainties related to agricultural subsidy payments and the payment of public employees' 13th month salaries. Therefore, this difference might turn out lower, thereby increasing the ESA 95 deficit in 2004. (ii) If the refunds of VAT would be accelerated, as was indicated by the Hungarian authorities, they might increase the deficit of 2004 by almost 0.7 percentage points[8].

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6 It was based on the Commission Spring 2004 economic forecast, which took into consideration data reported by Hungary in March 2004. The September 2004 notification corrected the general government deficit for 2003 upwards from 5.9% of GDP to 6.2%.

7 http://europa.eu.int/comm/economy_finance/about/activities/sgp/edp/com_ass_hu_22_dec_en.pdf

8 In order to prevent this and to bring the classification in line with deadlines for refunds, the Hungarian authorities intend to re-classify the part of March 2004 VAT refunds to the budgetary year 2003, which is still originating from 2003, but was classified according to the present accounting rules to the 2004 deficit – herewith lowering the 2004 ESA 95 deficit.

Box 2: The shortfall of VAT revenues in 2004

The revenue and expenditure projections in the Hungarian annual budget are presented in cash terms. While there was a constant divergence between accrual data and cash data in recent years, the difference in 2004 was expected to be particularly pronounced due to EU accession. The main reason was a delay of 1 to 2 months in import-related VAT settlements after EU accession as a consequence of changes in the VAT import regulation, which reduced 2004 VAT revenues in cash terms. According to the Hungarian authorities, it was especially difficult to predict the developments of these VAT revenues in 2004. While this factor applies only in the year of accession and in principle does not affect accrual figures, it created a forecasting uncertainty. The difference between the cash and accrual figure was originally assumed to be 1.2 percentage points of GDP, but was later corrected to 1.4 percentage points together with the upward revision of the budget target (e.g. the equivalent of the 5.3% of GDP accrual deficit was expected to be a cash deficit of 6.7% of GDP).

Apart from this uncertainty, the VAT revenue structure of 2004 revealed further serious distortions manifesting themselves in shortfalls compared to the forecasts. Against this background, the authorities withheld the refund of VAT import revenues at the end of 2004 (reaching up to 0.7% of GDP) in order to investigate the reasons for this shortfall. Apart from the fact that the reinforced control might contribute to reducing tax fraud, the delay in the refunds might result in a lower 2004 general government deficit, which would, though, show up as a higher deficit in 2005. However, according to recent indications by the authorities it is expected that the refunds would be accelerated so that they would barely affect the 2005 budget (see also footnote 6 of previous section).

5. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES

5.1. Evolution of budgetary targets in successive programmes

Similarly to the May 2004 convergence programme, the budgetary strategy underlying the update aims to reduce the general government deficit to below 3% of GDP by 2008, also with a view to fulfilling the convergence criteria by that date, so as to make possible the euro adoption in 2010. However, while keeping the slightly modified end-target of 2.8% of GDP (instead of 2.7% of GDP) in 2008, in the light of the missed target of 2004, compared to the May convergence programme, the update delays the previously more front-loaded adjustment and foresees a more gradual deficit reduction until 2008. After an estimated correction by 0.9 percentage point of GDP in 2004 to a deficit of 5.3% of GDP, it envisages an annual reduction of some 0.6-0.7 percentage point of GDP for the remaining years, higher than the ½ percentage point annual reduction planned in the previous update.

Following a decision of the Hungarian authorities in December 2004, the update applies a temporary methodological change compared to the May 2004 programme: it subtracts the burden of the 1998 pension reform from the general government deficit, amounting to between 0.8 and 1 percentage point of GDP between 2004 and 2008. This temporary re-classification, which is permitted by Eurostat until the March 2007 fiscal notification, lowers the yearly deficit figures compared to the May 2004 programme by 0.8-1.0 percentage point of GDP between 2004 and 2008. This assessment, however, continues to use the non-adjusted figures excluding the burden of the pension reform along with the adjusted numbers. This is not only to allow a comparison with the May programme and

an easier understanding, but also because, in the last two years of the programme period, the deficit numbers will not be reported anymore without the pension reform burden.

Table 3: Evolution of budgetary targets in successive programmes

		2003	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance (% of GDP)	CP Dec 2004 (adjusted by pension reform)	-5.5	-4.5	-3.8	-3.1	-2.4	-1.8
	(non-adjusted by pension reform)	**-6.2**	**-5.3**	**-4.7**	**-4.1**	**-3.4**	**-2.8**
	CP May 2004	-5.9	-4.6	-4.1	-3.6	-3.1	-2.7
	PEP August 2003	*-4.8*	*-3.8*	*-2.8*	*-2.5*	*n.a.*	*n.a.*
General government expenditure (% of GDP)	**CP Dec 2004**	**49.8**	**49.3**	**47.4**	**46.9**	**45.6**	**45.2**
	CP May 2004	50.4	48.8	47.5	46.5	46.3	46.7
	PEP August 2003	*48.0*	*48.2*	*47.0*	*46.1*	*n.a.*	*n.a.*
General government revenues (% of GDP)	CP Dec 2004 (adjusted by pension reform)	44.3	44.8	43.6	43.8	43.2	43.4
	(non-adjusted by pension reform)	**43.6**	**44.0**	**42.7**	**42.8**	**42.2**	**42.4**
	CP May 2004	44.5	44.2	43.4	42.9	43.2	44.0
	PEP August 2003	*43.2*	*44.4*	*44.2*	*43.6*	*n.a.*	*n.a.*
Real GDP (% change)	**CP Dec 2004**	**3.0**	**3.9**	**4.0**	**4.2**	**4.3**	**4.6**
	CP May 2004	2.9	3.3-3.5	3.5-4	cca.4	4-4.5	4.5-5
	PEP August 2003	*cca.3.5*	*cca.3.5*	*4 -4.5*	*4.5- 5*	*n.a.*	*n.a.*

Sources:
Convergence programmes of May and December 2004 (CP); Pre-accession economic programme of August 2003 (PEP)

5.2. Budgetary targets in the updated programme

As mentioned above, the budgetary strategy in the programme targets a gradual reduction of the headline deficit between 2004 and 2008 by 0.6-0.7 percentage points of GDP annually, bringing the (non-adjusted) deficit down from an estimated 5.3% of GDP in 2004 to 2.8% in 2008. The adjusted general government deficit path according to the methodology subtracting the pension reform burden would be 4.5%, 3.8%, 3.1%, 2.4% and 1.8% of GDP between 2004 and 2008. The (non-adjusted) primary deficit would follow a similar path as the general government deficit, an improvement of 1.2 percentage point of GDP in 2004 would be followed by a gradual decline of about 0.3-0.4 percentage points of GDP during the remainder of the programme period. It would turn into a slight surplus in 2008.

Similarly as foreseen in the May 2004 programme, the update aims to achieve consolidation through a significant reduction of the expenditure-to-GDP ratio, by some 4% of GDP between 2004 and 2008. This would be accompanied by a reduction of the revenues-to-GDP ratio by some 1½% of GDP.

The most pronounced expenditure reduction would be carried out in 2005. However, the planned fall for 2005 is mainly based on a 0.5 percentage point of GDP decline in the interest burden, and by a 1.7 percentage point of GDP expenditure reduction for public investment purposes which is planned to be substituted by public-private partnership (PPP) projects. This large decline in public investment expenditure in 2005 would be only partly compensated in the following years leading to a decrease of public investment by 0.6 percentage point of GDP between 2004 and 2008. In comparison, the

May 2004 programme still projected an increase in the GDP share of public investment by 1.5 percentage points over the same period. There is a risk concerning the timely adoption of intended reform measures constituting the base of future expenditure cuts. Furthermore, most of the expenditure-reducing measures already contained in the 2005 budget are not backed by comprehensive reforms. They have a rather ad-hoc character and their medium-term effects are neither clearly defined nor quantified so that the expenditure strategy of the outer years appears to be subject to uncertainty. Information about the headline expenditure figures in the update shows an increasing reduction in collective consumption and social transfers from 2006 onward (see section 7).

On the revenue side, a change in the tax and contribution system was included in the 2005 budget (see box 3). This mainly consists of a change in the personal income tax system and in some smaller tax categories, resulting in an assumed drop in tax revenues by 0.35 percentage points of GDP between 2004 and 2005. However, two thirds of this decline is assumed to be due to one-off effects (such as the vanishing of customs revenues after EU-accession and the non-valorisation of some excise taxes). For the outer years the update projects a further decline in the revenue-to-GDP ratio from some 39% of GDP in 2005 to about 37% of GDP in 2008.

Table 4: Composition of the budgetary adjustment

(% of GDP)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**Change: 2008-2004**
Revenues	**44.3**	**44.8**	**43.6**	**43.8**	**43.2**	**43.4**	**-1.4**
of which:							
- Taxes & social security contributions	39.9	39.3	38.9	38.6	38.1	37.6	-1.7
- Other (residual)	4.4	5.5	4.7	5.2	5.1	5.8	0.3
Expenditure	**49.8**	**49.3**	**47.4**	**46.9**	**45.6**	**45.2**	**-4.1**
of which:							
- Primary expenditure	45.6	44.9	43.5	43.4	42.4	42.2	-2.7
of which:							
Gross fixed capital formation	3.4	3.5	1.8	2.9	2.7	2.9	-0.6
Collective consumption	10.5	9.6	9.3	8.8	8.6	8.3	-1.3
Social benefits in kind	12.1	11.2	11.0	10.4	10.1	9.8	-1.4
Transfers other than in kind & subsidies	15.7	16.7	16.6	16.6	16.2	16.1	-0.6
Other (residual)	3.9	3.9	4.8	4.7	4.8	5.1	1.2
- Interest payments	4.2	4.4	3.9	3.5	3.2	3.0	-1.4
Budget balance adjusted by pension reform	-5.5	-4.5	-3.8	-3.1	-2.4	-1.8	2.7
Budget balance not adjusted by pension reform	**-6.2**	**-5.3**	**-4.7**	**-4.1**	**-3.4**	**-2.8**	**2.5**
Primary balance adjusted by pension reform	-1.6	-0.3	0.0	0.3	0.7	1.1	1.4
Primary balance not adjusted by pension reform	**-2.3**	**-1.1**	**-0.9**	**-0.7**	**-0.3**	**0.1**	**1.2**

Sources:
Convergence programme update; Commission services calculations

Box 3: The 2005 budget

Under the assumption of real GDP growth at 4%, the 2005 budget targets a decline in the general government deficit from 5.3% of GDP in 2004 to 4.7% of GDP in 2005, an improvement by 0.6 percentage point of GDP. Expenditure restraint is planned to stem notably from (i) a strong one-off effect resulting from the 1.7 percentage point of GDP reduction of public investment expenditure and its substitution by PPP projects; (ii) a reduction of the interest burden by 0.5 percentage point of GDP; (iii) savings as a result of the efforts to create a smaller and more efficient public sector and to tighten education and health expenditure. On the revenue side the 2005 budget projects a decline in the revenue ratio of 1 percentage point of GDP, from 44.5% to 43.5% of GDP, partly due to one-off and carry-over effects from 2004, and partly to a cut in the personal income tax in the 2005 budget (by merging the medium income bracket into the lowest one). The budget contains an “emergency” reserve package of 0.5% of GDP against a possible overshooting of the 2005 target, which is intended to cover unforeseen adjustments to developments which are not under the control of the government.

The adjustment path described in the programme and in particular the new deficit target for 2005 of 4.7% of GDP (3.8% of GDP excluding the burden of pension reform) can be considered appropriate to correct the excessive deficit by 2008 provided that it is backed by sufficient measures. However, the final target of 2.8% of GDP (1.8% of GDP according to the temporary classification excluding the burden of the pension reform) only leaves a small safety margin.

The main risks to the 2005 budget outcome are that interest expenditures could turn out higher than forecast, that the newly introduced rules for expenditure restraint may be insufficient or ineffective and that some revenue items, like VAT and social security might fall short. The Commission services Autumn 2004 forecasts projected a 2005 deficit of 5.2% of GDP (applying the methodology of non-adjusted figures), which would amount to a total slippage of 0.5 percentage point of GDP with respect to the new 2005 budget target. Information since the Autumn forecast added some risks: (i) risks regarding the transfer of ongoing public expenditures into PPP arrangements are increasing. (ii) There could also be a risk from the fact that VAT refunds originating from economic activities in 2004 have been delayed, although the authorities have committed to accelerate these refunds so that they will not burden the 2005 budget (on accrual basis). On the other hand, the risk of revenue slippages might somewhat be reduced due to the better control of VAT refunds.

Several risks can also be identified for the outer years. First, the macroeconomic scenario being rather on the optimistic side suggests that revenues could turn out lower than expected and expenditures higher. Second, the 2005 budget contains some structural measures, but they do not appear to be sufficiently comprehensive or far-reaching to ensure the envisaged medium-term expenditure restraint. The comprehensive structural reforms (see section 7), which would support medium-term expenditure control, still would have to be adopted in order to contribute to the deficit reduction beyond 2005[9].

[9] Most of the expenditure reducing measures are only incorporated into the 2005 budget, but are not having per se an effect in the further years (for example the freeze of the use of carried-over appropriation). Furthermore, given the lack of information about the detailed budgetary impact of the described and envisaged measures and the foreseen more comprehensive reforms, as well as the assumed budgetary burden of the planned PPP projects, a breakdown and detailed assessment of the main expenditure items is not possible.

Given that 2006 is a double election year with parliamentary and municipality elections, their implementation may be at risk[10]. There are also concerns about the credibility of the expenditure targets, since all the objectives set in the May programme were missed by a large margin, contributing to a systematic postponement of the budgetary adjustment. Third, the favourable interest rate assumptions of the update, based on a further restoration of confidence, constitute a budgetary risk for the whole adjustment period.

Table 5: **Budgetary targets and output gaps**

	2003		2004		2005		2006		2007	2008	Change: 2008-2004
	COM	CP	COM	CP	COM	CP	COM	CP	CP	CP	CP
Budget balance adjusted by pension reform[2]	.	-5.5	.	-4.5	.	-3.8	.	-3.1	-2.4	-1.8	2.7
Budget balance not adjusted by pension reform[2]	**-6.2**	**-6.2**	**-5.5**	**-5.3**	**-5.2**	**-4.7**	**-4.7**	**-4.1**	**-3.4**	**-2.8**	**2.5**
Output gap[1,3]	-0.7	-1.0	-0.6	-1.1	-0.7	-1.0	-0.7	-0.8	-0.4	0.2	1.3

Notes:
[1]CP (convergence programme): Commission services calculations on the basis of the information in the programme
[2]in percent of GDP
[3]in percent of potential GDP
Sources:
Commission services Autumn 2004 economic forecasts (COM); Commission services calculations

The economic policies outlined in the update are partly consistent with the country-specific broad economic policy guidelines in the area of public finances. The general government deficit was to be reduced "in a credible and sustainable way within a multi-annual framework in line with the decisions to be taken by the Council in the context of the budgetary surveillance exercise". However, Hungary has not complied with the 104(7) recommendations of the Council of 5 July 2004 under the excessive deficit procedure, as decided by the Council on 18 January 2005 based on Article 104(8) of the Treaty. The update retains a multi-annual framework for correcting the excessive deficit by 2008, but as mentioned above, there is a risk of worse-than-projected budgetary outcome.

5.3. Sensitivity analysis

According to the Hungarian authorities, the sensitivity coefficient of the government balance to changes in GDP is 0.3. According to the update, new calculations reveal that the deficit is less sensitive to inflation, so that 1 additional percentage point of inflation causes a 0.11 percentage point lower deficit, and an upward shift by 1 percentage point in the yield curve raises the deficit by 0.10 percentage point (in the first and second year as well).

[10] This should also be seen against the background of recent announcements of the Hungarian prime minister that the foreseen comprehensive reforms in these two sectors will be postponed until 2006.

Box 4: The treatment of PPPs in government accounts

Hungary, alongside with several other EU governments, has become very active in the organisation of public-private partnerships (PPPs). Such partnerships imply long-term contracts between government and private enterprises for the provision of public-use infrastructure. In ESA 95 accounts, the critical issue is whether the assets are considered as economically owned (irrespective of legal ownership considerations) by the government or by the private partner. If the asset is economically owned by the government, then the construction cost are registered as government investment expenditure; if the assets is economically owned by the private partner then construction cost is recorded as private investment. The fact whether payments by the government to the partner take place during the construction or later is not decisive. The economic ownership depends on who is bearing most of the risks attached to the execution of the contract. In case most risks are borne by the government, then the government is the economic owner of the new asset and the construction costs are booked as government investment with a detrimental impact on the government deficit and debt.

On 11 February 2004, Eurostat decided that the risk issues (and the economic ownership of assets) should be assessed according to three criteria on the construction risk (related to events during the construction phase, such as additional construction costs, late delivery, technical deficiency), availability risk (related to the operation of the asset, such as the volume of quality of services provided by the asset) and demand risk (related to the variability of demand by final users). Assets can be booked outside government accounts only if the private partner bears (i) the construction risk and (ii) either the availability or the demand risk. Therefore it is only in the cases government shifts most risks to the private sector that the construction cost of new assets through PPPs is postponed to future government deficits.

**Eurostat News Release N° 18/2004. For more details, see Chapter IV.4.2 (Long-term contracts between government units and non-government partners) of the Eurostat Manual of government deficit and debt. This manual collects the Eurostat decisions on the interpretation of ESA95 accounting rules on government transactions.*

6. EVOLUTION OF THE DEBT RATIO

According to the update, the debt ratio, which rose to 59.9% of GDP (57.3% of GDP excluding the pension reform burden) in 2004, will gradually decrease during the period covered by the programme, thereby remaining below the 60% of GDP reference value throughout the programme period. The reasons for the higher-than-projected debt outcome in 2004 can be attributed to the slippage in the 2004 deficit target. The gradual reduction would start in 2005, triggered by the continuous decrease of the general government deficit and the declining interest burden on the debt stock. The comparison between the Commission services Autumn 2004 forecast and the current update confirms that the main differences in the evaluation of the path of the debt-to-GDP ratio arise from the higher optimism of the budgetary projections of the update (see table 6a and 6b below).

The gradual reduction of the debt stock is planned to be supported by a change in the debt management strategy. The share of euro-denominated financing (27-32% of the total

debt at the moment) would increase and its recalculation period would decline in 2005. This in turn would contribute to the envisaged savings in interest expenditure (0.1-0.2% of GDP in 2005 compared to interest payments calculated under the assumption of an unchanged debt management strategy).

Table 6 a: Debt dynamics[11]

	average 2000-2003	**2004**		**2005**		**2006**		**2007**	**2008**
	COM	**COM**	**CP**	**COM**	**CP**	**COM**	**CP**	**CP**	**CP**
Government gross debt ratio	**56.3**	**59.7**	**57.3**	**59.5**	**55.3**	**58.9**	**53.0**	**50.6**	**48.3**
Change in debt ratio (1 = 2+3+4)	-0.4	0.6	-1.8	-0.3	-2.0	-0.5	-2.3	-2.4	-2.3
Contributions:									
- **Primary balance** (2)	**1.0**	**1.1**	**0.1**	**1.2**	**-0.1**	**1.1**	**-0.4**	**-0.8**	**-1.2**
- **"Snow-ball" effect** (3)	**-1.9**	**-1.1**	**-1.0**	**-0.5**	**-0.8**	**-0.8**	**-0.9**	**-0.8**	**-0.8**
- Interest expenditure	4.7	4.4	4.4	4.0	3.9	3.6	3.5	3.2	3.0
- Real GDP growth	-2.0	-2.1	-2.1	-2.0	-2.1	-2.1	-2.1	-2.1	-2.2
- Inflation(GDP deflator)	-4.6	-3.4	-3.3	-2.5	-2.6	-2.2	-2.3	-1.8	-1.7
- **Stock-flow adjustment** (4)	**0.4**	**0.6**	**-0.9**	**-0.9**	**-1.1**	**-0.9**	**-1.0**	**-0.8**	**-0.3**
- Cash/accruals	0.1								
- Accumulation of financial assets	0.1								
of which: Privatisation proceeds	*-0.6*								
- Valuation effects & residual adj.	0.1								

Note:
The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the "snow-ball" effect.

Sources:
Convergence programme update (CP); Commission services autumn 2004 economic forecasts (COM); Commission services calculations

[11] The transitional period granted by Eurostat on 23 September 2004, which led Hungary to adjust its deficit and debt figures in comparison to the convergence programme of May 2004, concerns the sectoral classification of 2nd-pillar pension schemes. Therefore the government accounts adjusted for the pension reform costs in the Hungarian convergence programme correspond to government (as defined in ESA95) plus the 2nd pillar pension scheme. This extension of the government sector leads to a reduction in the government gross debt. Typically, pension schemes accumulate financial assets and do not have debt. The pension scheme holdings in government bonds are then consolidated when compiling the government debt adjusted for the pension reform. Therefore, the difference between the two alternative debt figures in tables 7a and 7b corresponds to the pension scheme holdings in government bonds. The difference in the stock-flow adjustments in the two tables correspond to the accumulation of non-government paper by the 2nd pillar. Figures in tables 7a and 7b suggest that the 2nd pillar in Hungary invest most of their surpluses in government bonds.

Table 6 b: Debt dynamics (not adjusted for pension reform)

	average 2000-2003	2004		2005		2006		2007	2008
	COM	COM	CP	COM	CP	COM	CP	CP	CP
Government gross debt ratio	**56.3**	**59.7**	**59.9**	**59.5**	**58.6**	**58.9**	**56.8**	**54.9**	**53.2**
Change in debt ratio (1 = 2+3+4)	-0.4	0.6	0.8	-0.3	-1.3	-0.5	-1.8	-1.9	-1.7
Contributions:									
- **Primary balance** (2)	**1.0**	**1.1**	**0.9**	**1.2**	**0.8**	**1.1**	**0.6**	**0.2**	**-0.2**
- **"Snow-ball" effect** (3)	**-1.9**	**-1.1**	**-1.0**	**-0.5**	**-1.0**	**-0.8**	**-1.2**	**-1.0**	**-1.1**
- Interest expenditure	4.7	4.4	4.4	4.0	3.9	3.6	3.5	3.2	3.0
- Real GDP growth	-2.0	-2.1	-2.1	-2.0	-2.2	-2.1	-2.3	-2.3	-2.3
- Inflation (GDP deflator)	-4.6	-3.4	-3.3	-2.5	-2.7	-2.2	-2.4	-2.0	-1.8
- **Stock-flow adjustment** (4)	**0.4**	**0.6**	**0.9**	**-0.9**	**-1.1**	**-0.9**	**-1.2**	**1.1**	**-0.4**
- Cash/accruals	0.1								
- Accumulation of financial assets	0.1								
of which: Privatisation proceeds	*-0.6*								
- Valuation effects & residual adj.	0.1								

Note:
The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the "snow-ball" effect.

Sources:
Convergence programme update (CP); Commission services autumn 2004 economic forecasts (COM); Commission services calculations

7. STRUCTURAL REFORM AND THE QUALITY OF PUBLIC FINANCES

The May 2004 convergence programme announced structural reforms (in particular in the areas of public administration, education and health) to back the expenditure control underlying its strategy. The 2005 budget contains a number of measures aimed at improving efficiency in the central public sector. However, these do not correspond with the plans of the May programme. While the update gives more details about specific planned reform steps, it still does not quantify their expected effects nor does it detail their state of implementation. This might indicate that, given political sensitivities regarding the more comprehensive reforms of the health and education sector, they are likely to be postponed after the double elections in 2006 (as was also recently indicated by the Prime Minister). A more pronounced structural reform in the public sector, including the downsizing of public employment after a re-prioritisation of the tasks, did also not take place. Staff reduction is encouraged in all sub-sectors of government through a reduction in the appropriations for public salaries. However, it is questionable whether this will result in a decline of public sector employment of the desired scale by about 10% in 2005, as envisaged in the 2005 budget and in the update, since the different government units and agencies might assume the cut in appropriations to be temporary and save rather on operational expenditure. This seems especially relevant for

government units outside of central government, where central influence on staff decisions appears more limited.

Concerning the health-care system, the May 2004 convergence programme announced a comprehensive reform as one of the means to reduce expenditure. While no major steps have been taken since the May programme, budgetary rules were put in place to curb the recent increase in in-kind expenditures. At the same time, the scope of the "managed care" type of health care provision is to be broadened from one fifth of the population to half of the population. It should however be noted that this will not lead to immediate expenditure savings but will introduce mechanisms that can be conducive to cost containment in the future, including in a setting of an ageing population. The risks of overspending on pharmaceutical subsidies have been limited by an agreement between the Hungarian government and pharmaceutical producers (which foresees a joint financing of overspending, up to a certain amount, above which the whole excess spending has to be borne by the producers). Additional efforts for a health-care system reform should be pursued.

The May 2004 convergence programme also announced a reduction of the high tax burden during the programme period, coupled with the simplification of the in-transparent tax system. In the light of the tax changes with effect in 2005 (mainly a change in the personal income tax system and in some smaller tax categories) there is an assumed drop in tax revenues by 0.35 percentage points of GDP between 2004 and 2005. However, two thirds of this decline is assumed to be due to one-off effects (such as the vanishing of customs revenues after EU-accession and the non-valorisation of some excise taxes). The further reduction in the 2005 budget of the previously large number of possible tax exemptions are positive achievements, and the changes in the tax and social security system are in line with the recommendation to Hungary in the broad economic policy guidelines for the period 2003-2005 to ensure that the tax and benefit systems support employment and provide incentives to enter or remain in the labour market and to further reduce the high tax burden on labour.

8. THE SUSTAINABILITY OF THE PUBLIC FINANCES

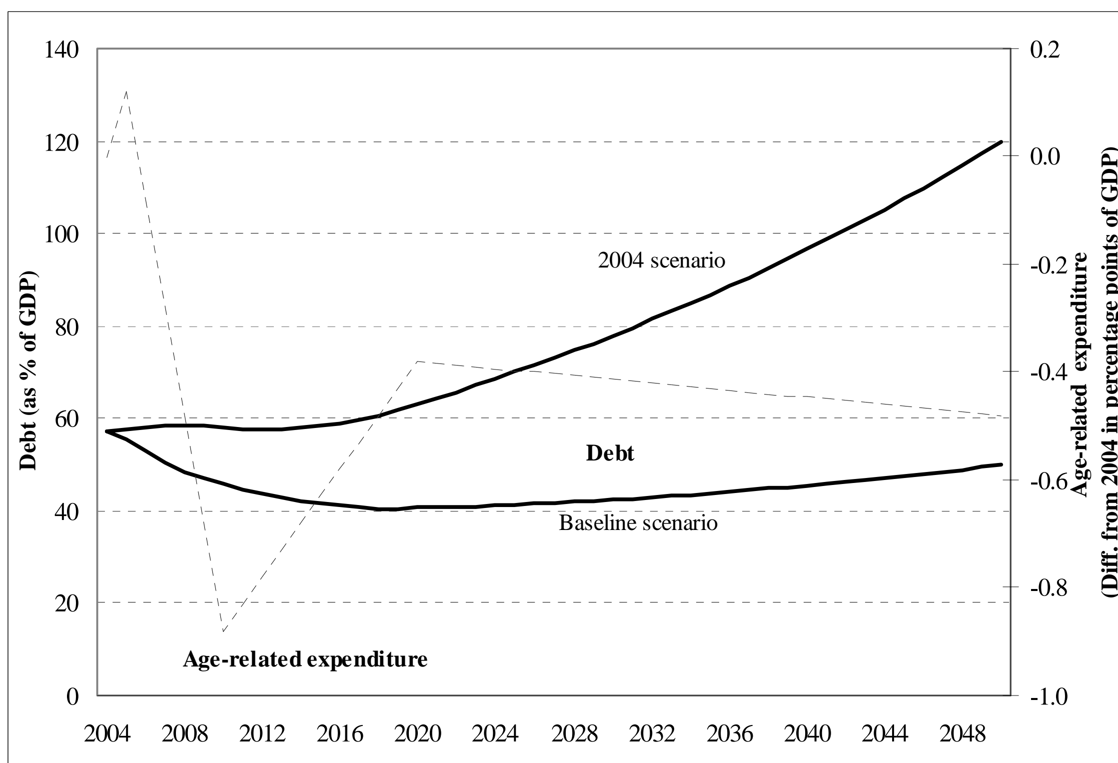
The assessment of the sustainability of the Hungarian public finances is based on an overall judgement of the results of quantitative indicators and qualitative features. The quantitative indicators project debt developments according to two different scenarios, to take into account different budgetary developments over the medium term. The "programme" scenario (baseline) assumes that the medium-term objective set in the programme is actually achieved, while the "2004" scenario assumes that the underlying primary balance remains throughout the programme period at the 2004 level.

The graph below presents gross debt developments according to the two different scenarios. On the basis of the programme, pension expenditure from the first pillar (without pensions financed from the Health Insurance Fund) is foreseen to increase by 0.2% of GDP between 2009 and 2050.[12] This trend benefits from the impact of the measures undertaken in the context of the pension reform in 1997.

[12] In the long-term projections in the Hungarian update of the convergence programme, pension expenditures from the funded defined contribution pension scheme were not considered. For consistency, the pension contributions (included in government revenues in the medium-term scenario in the update) were excluded in the projections, amounting to 1% of GDP in 2004-2008. It is also

Given that in the update no projections are available for other age-related expenditures such as health care or education, it is not possible to estimate the overall pressure on the long-term sustainability of the public finances resulting from population ageing in Hungary. On the basis of the available information, gross debt is projected to remain broadly stable during the projection period.[13] However, the debt dynamics would worsen if the expected consolidation path in the programme period does not materialise; gross debt is projected to reach around 120% of GDP in 2050, which could lead to an explosive debt path beyond that date.

Long-term sustainability: summary results



Sustainability indicators

	S1*	S2**	RPB***
Baseline scenario	-0.2	0.6	1.1
2004 scenario	1.2	1.9	1.3

Notes:

* It indicates the required change in tax revenues as a share of GDP over the projection period that guarantees to reach debt to GDP ratio of 60% of GDP in 2050.

** It indicates the required change in tax revenues as a share of GDP that guarantees the respect of the inter-temporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon to the debt as existing at the outset of the projection period; p.m. debt to GDP ratio in 2050: 19.2%.

*** Based on S2, the Required Primary Balance (RPB) indicates the average minimum required cyclically adjusted primary balance as a share of GDP *over the first five years* of the projection period that guarantees the respect of the inter-temporal budget constraint of the government.

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worth noting that in 2008, the projected level of the accumulated assets of private pension funds (mandatory second pillar) in 2005 is expected to reach 4.6% of GDP.

[13] It should be recalled that, being a mechanical, partial equilibrium analysis, projections are in some cases bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels is not a forecast of likely outcomes and should not be taken at face value.

On the basis of the debt projections, it is possible to calculate a set of sustainability indicators to measure the gap between the current policies and a sustainable one. The S1 indicator shows the permanent change in the primary balance in order to have a debt to GDP ratio in line with the Maastricht Treaty reference value in the very long run (year 2050).[14] S2 shows the gap between the current tax policies and those that would ensure respect of the inter-temporal budget constraint given the future impact of ageing on public expenditure, namely the change in the tax ratio that would equate the present discounted value of future primary balances to the current stock of gross debt. According to the latter, in order to tackle the cost of ageing entirely, Hungary should increase its tax ratio permanently by at least 0.6 percentage points of GDP compared with the projected one at the end of the programme period. This would lead to a sustainable debt ratio of around 20% of GDP by the middle of this century[15]. The budgetary effort over the first 5 years of the projections (i.e. after the end of the programme period) to respect the intertemporal budget constraint requires a primary surplus of just above 1% of GDP on average, compared with a primary surplus of 0.2% of GDP targeted for the last year of the programme period, in the light of the exclusion of the second pillar pension contributions.

The assumptions underlying the projected long-term dynamics of pension expenditures of the update appear realistic, and are broadly in line with historical experience.

It seems that measures associated with the reform of the Hungarian pension system of 1998 contribute significantly to a reduction of ageing-related pressures on the public finances. The direct link between contributions and pensions, together with private ownership of individual accounts, has made the second pillar popular. Already in 2000, around half of all economically active persons participated in the second pillar. However, measures such as the gradual introduction of the 13th month's pension are somewhat counterproductive from the point of view of sustainable long-term finances.

On the macroeconomic assumptions, while it seems realistic that over time the currently relatively low participation rate compared to the EU-15 average would catch up, the projected increase in female participation appears to be rather on the optimistic side. Accordingly, the constantly low unemployment rate over the whole observation period seems to be optimistic.

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[14] The respect of the underlying debt path does not ensure sustainability over an infinite horizon, but only that debt remains below 60% up to 2050. In most cases, this would imply an increasing trend and possible unbalances after the end of the projection period.

[15] The debt ratio of around 20% in 2050 according to the S2 indicator illustrates that the sustainability gap is higher in order to ensure a sustainable evolution of gross debt beyond 2050, compared with the S1 indicator, which illustrates that a lower budgetary strengthening is compatible with the 60% reference value in 2050.

Annex 1[16]: Summary tables from the convergence programme update

Table 1. Growth and associated factors

	ESA Code	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
GDP growth at constant market prices (7+8+9)	B1g	3.0	3.9	4.0	4.2	4.3	4.6
GDP level at current market prices HUF billion	B1g	18568	20450	22270	24200	26150	28280
GDP deflator		7.6	6.0	4.7	4.3	3.6	3.4
CPI change		4.7	6.8	4.5	4.0	3.5	3.0
Employment growth		1.3	0.5	0.9	1.0	1.0	1.4
Labour productivity growth		1.7	3.5	3.0	3.2	3.2	3.2
Investment ratio % GDP		22.3	22.9	23.4	24.1	24.7	25.3
Sources of growth : percentage changes at constant prices							
1. Private consumption expenditure	P3	8.1	3.1	3.8	3.4	3.5	3.9
2. Government consumption expenditure	P3	5.3	0.3	-1.0	0.6	0.8	0.8
3. Gross fixed capital formation	P51	3.4	9.0	7.3	7.9	7.7	8.4
4. Changes in inventories and net acquisition of valuables as a % of GDP	P52+P53	-0.1	-0.3	0.1	0.4	0.7	0.7
5. Exports of goods and services	P6	7.6	14.0	11.0	10.4	9.5	9.2
6. Imports of goods and services	P7	10.4	12.9	10.7	10.1	9.3	8.9
Contribution to GDP growth							
7. Final domestic demand	P3	6.6	4.1	3.9	4.2	4.3	4.8
8. Change in inventories and net acquisition of valuables	P3	-1.0	-0.2	0.4	0.3	0.3	0.0
9. External balance of goods and services	P51	-2.5	0.0	-0.3	-0.3	-0.3	-0.2

[16] Data provided by the Hungarian authorities in the convergence programme update.

Table 2. General government budgetary developments[17]

% of GDP	ESA code	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
Net lending (B9) by subsectors							
1. General government	S13	-5.5	-4.5	-3.8	-3.1	-2.4	-1.8
2. Central government	S1311	-4.1	-3.2	-2.9	-1.3	-0.7	-0.6
3. State government	S1312	-	-	-	-	-	-
4. Local government	S1313	0.0	0.1	-0.2	-0.4	-0.3	-0.2
5. Social security funds	S1314	-1.4	-1.4	-0.7	-1.4	-1.4	-1.0
General government (S13)							
6. Total receipts	ESA	44.3	44.8	43.6	43.8	43.2	43.4
7. Total expenditures	ESA	49.8	49.3	47.4	46.9	45.6	45.2
8. Budget balance	B9	-5.5	-4.5	-3.8	-3.1	-2.4	-1.8
9. Net interest payments		-3.9	-4.2	-3.8	-3.4	-3.1	-2.9
10. Primary balance[18]		-1.6	-0.3	0.0	0.3	0.7	1.1
Components of revenues							
11. Taxes	D2+D5	26.4	25.9	25.5	25.4	25.2	24.7
12. Social contributions	D61	12.8	12.6	12.5	12.2	11.9	11.9
12a. pension reform		0.7	0.8	0.9	1.0	1.0	1.0
13. Interest income	D41	0.2	0.2	0.1	0.1	0.1	0.1
14. Other		4.2	5.3	4.6	5.1	5.0	5.7
15. Total receipts	ESA	44.3	44.8	43.6	43.8	43.2	43.4
Components of expenditures							
16. Collective consumption	P32	10.5	9.6	9.3	8.8	8.6	8.3
17. Social benefits in kind	P31	12.1	11.2	11.0	10.4	10.1	9.8
18. Social transfers other than in kind	D62	14.2	14.1	14.1	14.1	13.7	13.2
19. Interest payments	D41	4.2	4.4	3.9	3.5	3.2	3.0
20. Subsidies	D3	1.5	2.6	2.5	2.5	2.5	2.9
21. Fixed capital expenditures		3.4	3.5	1.8	2.9	2.7	2.9
22. Other		3.9	3.9	4.8	4.7	4.8	5.1
23. Total expenditures	ESA	49.8	49.3	47.4	46.9	45.6	45.2

[17] Adjusted data (cost of pension reform of 0.8% of GDP to 1% of GDP excluded in line with temporary classification permitted by Eurostat).

[18] Calculated using net instead of gross interest.

Table 3. General government debt developments

% of GDP	ESA code	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
Gross debt level		57.0	57.3	55.3	53.0	50.6	48.3
Change in gross debt		7.1	5.5	2.8	2.1	1.5	1.5
Contributions to change in gross debt							
Primary balance		1.6	0.4	0.0	-0.3	-0.7	-1.1
Net interest payments	D41	3.9	4.2	3.8	3.4	3.1	2.9
Nominal GDP growth	B1g	-5.5	-5.2	-4.7	-4.4	-4.0	-3.8
Other factors influencing the debt ratio		*1.4*	*-0.6*	*0.3*	*0.0*	*0.0*	*0.0*
of which: Privatisation receipts		*-0.3*	*-0.9*	*-0.5*	*0.0*	*-0.1*	*-0.1*
p.m. implicit interest ratio on debt (%)		7.4	8.1	7.3	6.7	6.4	6.2

Table 4. Cyclical developments

% of GDP	ESA code	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
1. GDP growth at constant prices	B1g	3.0	3.9	4.0	4.2	4.3	4.6
2. Actual balance	B9	-5.5	-4.5	-3.8	-3.1	-2.4	-1.8
3. Net interest paid	D41	-3.9	-4.2	-3.8	-3.4	-3.1	-2.9
4. Potential GDP growth		3.9	4.0	4.1	4.3	4.4	4.5
5. Output gap		-0.4	-0.4	-0.6	-0.6	-0.7	-0.4
6. Cyclical budgetary component		-0.1	-0.1	-0.2	-0.2	-0.2	-0.1
7. Cyclically-adjusted balance (2-6)		-5.4	-4.4	-3.6	-2.9	-2.2	-1.7
8. Cyclically-adjusted primary balance (7-3)		-1.5	-0.2	0.2	0.5	0.9	1.2

Table 5. Divergence from previous update

% unless otherwise indicated	ESA code	2003	2004	2005	2006	2007	2008
GDP growth (%)							
previous update	B1g	2.9	3.3 - 3.5	3.5 - 4.0	cca. 4.0	4.0 – 4.5	4.5 - 5.0
latest update	B1g	3.0	3.9	4.0	4.2	4.3	4.6
General government deficit (% of GDP)							
previous update	B9	5.2	3.9	3.3	2.7	2.2	1.8
latest update	B9	5.5	4.5	3.8	3.1	2.4	1.8
Gross debt levels (% of GDP)							
previous update		57.0	56.7	54.6	53.0	51.2	48.8
latest update		57.0	57.3	55.3	53.0	50.6	48.3

Table 6. Assumption of the external economic environment

Annual growth rates in %, if not otherwise indicated	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
Interest rates (in % p.a., annual averages)						
Hungary short term	8.20	11.21	7.84	6.06	5.66	5.45
Hungary long term	6.82	8.26	7.12	6.49	6.08	5.75
Euro area short term (3 months money markets)	2.30	2.10	2.60	3.50	…	…
Euro area long term (10 year govt bonds, lowest one prevailing in euro area)	4.10	4.20	4.60	4.80	…	…
USA short term (3 months money markets)	1.20	1.60	2.90	3.60	…	…
USA long term (10 year govt bonds)	4.00	4.30	4.70	5.30	…	…
Exchange rate						
HUF/Euro	253.5	254.5	254.5	254.5	254.5	254.5
GDP (in real terms)						
World (excl. EU)	4.4	5.7	4.8	4.6	4.4	4.2
USA	3.0	4.4	3.0	2.9	2.8	2.7
Japan	2.5	4.2	2.1	2.3	2.3	2.3
EU 15	-1.6	-0.3	0.0	0.3	0.7	1.1
World trade (in real terms)						
Hungarian export markets	3.9	7.2	7.2	7.0	6.8	6.5
World imports	5.1	11.6	8.8	8.3	8.0	6.8
International prices						
World import prices (goods in USD)	8.8	10.4	3.7	0.5	0.5	0.5
Oil prices (Brent- USD per barrel)	28.8	39.3	45.1	40.1	40.0	40.0
Non oil-commodity prices (USD)	6.5	12.9	-2.9	-0.5	0.0	0.0

Table 7. Long term sustainability of public finances

Annual growth rates in %, if not otherwise indicated	2000	2005	2010	2020	2030	2050
Total expenditures	47.7	47.4	43.8	…	…	…
Old age pensions	7.6	8.2	7.2	7.9	8.2	9.6
Health care (including care for the elderly)	…	…	…	…	…	…
Interest payments	5.6	3.9	2.8	…	…	…
Total revenues	45.2	43.6	43.0	…	…	…
of which: From pensions contributions	7.5	7.5	7.6	7.6	7.3	6.3
National pension fund assets	1.3	4.6	8.7	19.0	27.6	32.3
Assumptions						
Labour productivity growth	4.2	3.0	3.5	2.8	2.8	2.7
Real GDP growth	5.2	4.0	4.5	2.5	2.2	2.0
Participation rate males (aged 20-64)	69.3	69.3	69.9	71.9	71.3	70.5
Participation rate females (aged 20-64)	54.0	55.4	56.2	59.5	60.4	59.5
Total participation rate (aged 20-64)	61.5	62.2	62.9	65.6	65.8	65.0
Unemployment rate	6.4	4.9	5.5	5.0	5.0	5.0

Annex 2: Long-term sustainability of public finances in Hungary – quantitative scenarios

Main assumptions - baseline scenario (as % GDP)	2009	2010	2020	2030	2040	2050	changes
Total age-related spending	7.4	7.2	7.7	7.7	7.6	7.6	0.2
Pensions	7.4	7.2	7.7	7.7	7.6	7.6	0.2
*Total primary non age-related spending**	34.6						
*Total revenues**	42.4						

*constant

Results (as % GDP)	2009	2010	2020	2030	2040	2050	changes
Baseline scenario							
Gross debt	47.1	45.8	40.6	42.4	45.5	49.9	2.8
i + 0.5*	47.3	46.2	43.0	47.2	53.4	61.9	14.5
2004 scenario							
Gross debt	58.2	57.8	63.1	77.9	96.6	119.9	61.7
i + 0.5*	58.5	58.4	66.4	85.2	109.5	140.9	82.4

* i + 0.5 represents the evolution of debt under the assumption of the nominal interest rate being 50 basis points higher throughout the projection period.